

# Introducing Severance Payment Systems in Japan A Proposal for Vacancy Decontrol

著者（英）	Tatsuo Hatta
journal or publication title	AGI Working Paper Series
volume	2018-06
page range	1-60
year	2018-06
URL	<a href="http://id.nii.ac.jp/1270/00000142/">http://id.nii.ac.jp/1270/00000142/</a>

**Introducing Severance Payment Systems in Japan**  
**——A Proposal for Vacancy Decontrol——**

*Tatsuo Hatta*  
*Asian Growth Research Institute*

Working Paper Series Vol. 2018-6  
June 2018

The views expressed in this publication are those of the author(s) and do not necessarily reflect those of the Institute.

No part of this article may be used reproduced in any manner whatsoever without written permission except in the case of brief quotations embodied in articles and reviews. For information, please write to the Institute.

**Asian Growth Research Institute**

# Introducing Severance Payment Systems in Japan

## ——A Proposal for Vacancy Decontrol——

Tatsuo Hatta

Asian Growth Research Institute

June 15, 2018

### Abstract

In Japan, the court requires job restoration rather than a severance payment from a firm after it decides that a dismissal has been abusive. This results in a high settlement cost for termination.

This paper makes two proposals for introducing severance payments to reduce settlement costs in Japan. The first applies to existing contracts and proposes to specify levels of severance payments that would replace the current job restoration requirement after the court determines that a case is abusive.

The second applies to new employees either for a recently vacated position or a new position and proposes *vacancy decontrol*, which allows firms to set the levels of severance payments freely while also honoring the existing contracts. Within this category, this paper proposes *government-assisted vacancy decontrol*, a transitional measure, where the government sets a minimum level of statutory severance payment, which is equal to six months of wages for a worker who has worked for 20 years, following the Taiwan precedent. After the need for the transitional measure is dissolved, *complete vacancy decontrol* should be introduced, abolishing the statutory severance payment. We have proposed that even at this stage, the government should publicly set a default level of the severance payment, which a firm should observe unless an explicit agreement or contract stipulates otherwise. The government should immediately introduce some form of vacancy decontrol for senior workers who have already retired from a regular job.

**JEL Classification Codes:** J08, J38, J41, J48, J88, J83, K12, K31, K41, D61

**Key Words:** Dismissal regulation, vacancy decontrol, severance payment, Taiwan, exit payment, job restoration requirement, lifetime employment, Ponzi scheme, rapid economic growth, incomplete contract, human capital investment, Labor Standard Act, unemployment insurance, employment-at-will, seniority-based wage system.

**Acknowledgement:** I am deeply indebted to Professors Shinya Ouchi, Naohiro Yashiro, Mr. Howard Shiu, and other participants of the Conferences for their helpful comments and suggestions. I would also like to thank Mr. Hiroki Hoshina for competent assistance in preparing this article. Remaining errors are of course mine.

# Introduction

## *1. Adverse Effects of Barriers to Termination*

In Japan, the lack of predictability in court decisions on the abusiveness of a dismissal imposes a high settlement cost for termination. However, even after the court decides that dismissal has been abusive, the court rules prescribe job restoration rather than a severance payment, which drives the settlement cost for termination even higher. This large settlement cost for terminating employment in Japan practically requires a firm to provide lifetime employment for its regular workers. Hence, a seniority-based wage system is a virtual mandate for regular workers, given the legal system in Japan.

The practice of imposing a high cost on dismissal under the current Japanese employment system is often defended because it provides job security and incentives for workers to invest in firm-specific skills. However, as firms can conclude private contracts with different degrees of employment security and commensurate levels of wages, there is no reason to impose a high termination cost on these grounds statutorily.

On the other hand, the adverse effects of legal barriers to termination in Japan are overwhelming, as follows.

1. It shuts down opportunities for qualified mid-career persons to find employment in a firm because unqualified workers protected by the employment practice already occupy the positions.
2. The entire cohort could fall into an “ice age employment cohort,” which invokes significant economic inefficiency.
3. This system has in practice been unable to protect workers in small firms because of the high cost of litigation relative to their income.<sup>1</sup>

It would appear the primary beneficiaries of this system are unproductive

---

<sup>1</sup> See Section 4 of Yashiro [2018].

workers in large firms who would lose their employment without this protection, while the primary victims are qualified job seekers unable to secure employment at the beginning of their professional careers. The current employment system in Japan, therefore, needs significant reform.

## ***II. Proposed Reforms***

How can we reform this system? We cannot abandon the current system because already employed workers have a stake in its retention, even though their protection is at the expense of more qualified job seekers (outside workers.) Two reforms are in order.

### **1. Vacancy Decontrol**

#### ***Vacancy Decontrol in the Housing Market***

The first is the introduction of *vacancy decontrol*, applicable to new labor contracts for vacated positions or newly created positions while honoring existing contracts. This reform allows a firm employing new workers to set the amount of severance payment and any other dismissal conditions freely.

First used in the context of the regulatory reform of rent control, vacancy decontrol has a long history. During the postwar period, rent control existed in the central areas of many US cities. These controls protected the interests of residents fortunate to be already living in rent-regulated apartments, at the cost of newcomers who were willing to pay higher rents in rent-controlled areas.

During the 1980s, many cities, including Boston, adopted programs of vacancy decontrol. Rather than scrapping the rent control, these cities continued to protect the interests of those hitherto safeguarded under existing rent control. However, with the vacation of a rent-controlled apartment, rent control no longer was applied into that apartment,<sup>2</sup> i.e., the market determined the rent.

---

<sup>2</sup> In Japan, the so-called *Shakuchi-shakka Law* (Act on Land and Building Lease) played a similar role to the US rent controls, in that the owner could not refuse the renewal of a contract with a low rent. In 2000, a new Fixed Term Lease Law was legislated, and the tenant and owner can now choose which law applies. This yielded a form of vacancy decontrol.

### ***Complete Vacancy Decontrol***

A similar reform can be applied to the Japanese labor practice by allowing the various parties to conclude a new contract that freely sets dismissal conditions while honoring the existing contracts. Dismissal conditions in the new contracts can include the amount of severance payment, instead of requiring job restoration. We refer to this reform as *complete* vacancy decontrol. The labor market in the decontrolled sector would then become similar to the US labor market.<sup>3</sup> Note, however, that the US market functions under the following institutional settings.

Public unemployment insurance penalizes employers with frequent dismissals.

If complete vacancy decontrol is carried out in the economy where this setting does not exist, firms will be motivated to dismiss workers excessively from the welfare economics viewpoint.

### ***Government-assisted Vacancy Decontrol***

In countries where private agreements on severance payment are introduced as a result of vacancy decontrol, it may be useful for the government to set the minimum level of severance payment for all the new contracts, as a transitional measure.

We refer to this variant as *government-assisted* vacancy decontrol for new labor contracts. As with complete vacancy decontrol, this allows a firm to freely set the dismissal conditions when it employs a new worker. In this variant, however, the government sets the level of statutory severance payment for each new contract. Since the Japanese unemployment system does not satisfy the required setting for complete vacancy decontrol, the statutory severance payment

---

<sup>3</sup> In the US, “at-will” employment is constrained by statutory, public policy, and other exceptions. See National Conference of State Legislatures [2008]. For example, firing based on discrimination is deemed illegal. Within the bound, freedom of contract is honored. It is expected that a similar situation will prevail for the new contracts under the vacancy decontrol in Japan.

makes up for the lack of the institutional settings of the public unemployment insurance described above and smooth out other transitional problems that arise on the way to complete vacancy decontrol.

Incidentally, the 2005 reform of the Labor Standard Act in Taiwan introduced the New Pension Scheme, while allowing the workers who are working under the Old Scheme to choose between staying with the Old Pension Scheme or joining the New Pension Scheme. This situation is essentially a form of vacancy decontrol.

## **2. Improvement of the Protection of Existing Contracts**

The second reform is the introduction of statutory severance payment for existing contracts that are untouched by vacancy decontrol. A statutory severance payment then serves as a substitute for the job restoration requirement, which the court imposes when it rules that the dismissal of a worker has not satisfied the just cause. Given that job restoration is impractical in most cases, both employers and employees should prefer a severance payment in its place if they can agree upon an appropriate level of severance payment.

## ***III. Chapter Outline***

This chapter aims to demonstrate the appropriate level of severance payment if Japan was to adopt the government-assisted vacancy decontrol approach. We analyze the existing level of severance payment in Taiwan as a reference target for this approach. However, before discussing the appropriate level of severance payment, we need to examine whether Japan should keep the lifetime employment system effectively compulsory as it is now or let each firm choose it voluntarily. We also need to examine if the severance payment should be statutory or voluntary in different settings. The chapter proceeds as follows.

Part 1 reviews the history of the lifetime employment system in Japan and whether it should continue to enjoy government protection. Part 2 discusses whether the severance payment should be statutory or voluntary. Part 3 outlines the proposed reforms of the employment system in Japan which introduces two

types of severance payments: one for the existing contract and the other for new contracts. Lastly, Part 4 states the conclusion of this article.



# Part 1: Lifetime Employment System

## ***I. Choice or Mandate?***

There are two extreme categories of the wage system. The first is a *merit-based* wage system, where the wage rate is set equal to the marginal productivity of the worker at the time. The second is a *seniority-based wage system*, where the wage rate of a worker is lower than the productivity of the worker when young, and higher than the productivity of the worker when old. This system can function either with spontaneous no-dismissal agreements or under the statutory mandate.

### **1. Lifetime Employment in the US**

In the US, where no-dismissal agreements or contracts are not mandatory, many firms voluntarily adopt no-dismissal agreements with their workers.<sup>4</sup> IBM is a notable example, and other such firms include Hewlett-Packard, Maytag, and Nucor Steel.<sup>5</sup> Employment-based on a no-dismissal agreement in the US is nothing but the lifetime employment system in Japan.

### **2. Lifetime Employment in Japan**

Because of the high settlement cost of termination, many firms in Japan adopt the lifetime employment system. This system accounts for labor immobility in Japan in several ways.

First, a commitment to lifetime employment makes it difficult for a firm to replace unproductive with productive workers. A firm may employ a promising employee, only to find him disappointing after a couple of years of work. Under the lifetime employment system, the firm must retain him until retirement. Thus,

---

<sup>4</sup> "In the United States, the 'employment at will' doctrine implies that either party can break the employment relationship with no liability, provided there was no express contract for a definite term governing the employment relationship and as long as the employer has not entered into a collective bargain." [Cahuc et al. 2014, p. 882]. This implies that when there is an "express contract," the employer cannot break the employment contract. See Autor et al. [2006] for a precise description of the employment-at-will doctrine and its exceptions.

<sup>5</sup> Bellinger [1989].

even a well-established firm will find it difficult to hire a mid-career engineer who has accumulated the latest technological expertise through several years of experience in a small firm. This is because an engineer experienced with outdated technology, who appeared promising at the age of 22, is already occupying the position.

Second, the other side of the same coin is that the dominance of the mandatory lifetime employment system disadvantages the regular workers with high productivity. Prevalence of lifetime employment system prevents the development of flexible labor markets, which impedes an able worker from stepping up to a position in a different firm from the current position.

Third, many large firms employ mostly top-notch university graduates immediately after graduation. The reason is that under the constraint that the firm cannot dismiss the worker, the firms have to hire the workers who can cope with many unexpected situations in the future, rather than those who already have the skills the firms need now. To commit a worker that the firm will keep him even if he turns out to be unproductive implies that the firm is taking a risk in hiring. To minimize the risk, it would hire a graduate of better universities rather than someone who has the technology and know-how now.

Thus a mid-career person who has already accumulated skills in a particular area is crowded out from the regular job from the outset. If a firm can dismiss a worker, the risk associated with employing a new worker almost disappears. Thus the firm does not have to hire only the graduates of leading universities and will be eager to hire the skillful mid-career person.

Fourth, effectively compulsory lifetime employment system creates the so-called *employment ice age cohorts*. Many graduates from college in the middle of a recession fail to obtain regular jobs upon graduation will be unable to secure regular job for many years after graduation because firms prefer to employ new college graduates. Thus, the cohorts of college graduate during recessions are called employment ice age cohorts.

An employment ice age cohort can only exist if the lifetime employment system is mandatory or practically mandatory. Consider an economy where lifetime employment is optional but many firms still voluntarily select a lifetime

employment system. If a recession arises in this economy, the firms that did not opt for the lifetime employment system will be in an advantageous position because they will be able to recruit the excellent workers out of the pool of non-regular workers who failed to secure regular jobs, by dismissing the not-so-able mid-career workers. Hence, many firms will cease choosing the lifetime employment system, turning the employment ice age into a mere *low wage age*. Conversely, when lifetime employment is compulsory, few firms can absorb non-regular workers who are graduates of the recession periods, so the sporadic arrival of the employment ice age cohorts will be inevitable.

Fifth, non-regular workers are disadvantaged by the protection given to regular workers, because employers are more reluctant to change non-regular workers to regular workers when it is costlier to fire regular workers. As Cahuc et al. [2014, p. 882] points out, "...stronger protection for permanent workers may indeed help permanent workers to keep their jobs, but at the expense of the unemployed and temporary workers whose opportunities to get stable jobs are reduced by this form of job protection. This mechanism explains why insiders, who occupy permanent jobs, can advocate stringent employment protection legislation at the expense of the outsiders, who do not occupy permanent jobs."

Non-regular workers are disadvantaged in other ways also. When a firm has to dismiss workers because of economic hardship, the law obligates the firm to dismiss the non-regular workers first, even if they are more productive than the regular workers. Moreover, firms are given strong incentives to dismiss non-regular workers by the end of 5 years of work; otherwise, they are obligated to hire them permanently if the workers so wish.

The Japanese labor law system consistently disadvantages non-regular workers, while protecting in return the interests of the regular workers with low productivity.

Lastly, the legal framework that underpins lifetime employment in Japan has disadvantaged workers in a small firm and non-regular workers due to the high cost of litigation relative to their income. As judicial procedures sometimes take a long time and are costly relative to their income, most employees in small firms have a difficult time appealing to the court, unlike workers in large firms who are

typically backed by corporate trade unions<sup>6</sup>. As a result, small firms do not hesitate to dismiss their workers without the fear of litigation.

To sum up, mandatory lifetime employment imposes a high social cost in not permitting firms to employ able mid-career workers, in creating periodic employment ice age cohorts, and in failing to protect the job security of workers in small firms and non-regular workers.

## ***II. The History of the Lifetime Employment System in Japan***

### **1. The Origins of Lifetime Employment in Japan**

In the early postwar period in Japan, lifetime employment was not chief and coexisted with other wage systems. At the time, the court often accepted dismissal, respecting the spirit of the Civil Code that guaranteed the freedom of contracts. However, starting in the mid-1950s, as the economy started to grow fast, many firms in Japan began to implement lifetime employment systems, the main cause of which was rapid economic growth. The seniority-based wage system is equivalent to a merit-based wage system plus forced savings on employees by the employer. An advantage for the employee of the implicit savings in the seniority-based wage system is that the rate of return for these implicit savings can be higher than the market rate. Adopting a seniority-based wage system under a tacit understanding of lifetime employment was also profitable for firms, which could obtain a windfall gain even after paying an interest rate higher than the market rate for the implicit savings of its employees. This benefit to all parties is in part a Ponzi scheme that can only function during periods of rapid economic expansion.<sup>7</sup>

Let us briefly explain how the Ponzi scheme works in the context of a seniority-based wage system. When the economy is growing, and employment

---

<sup>6</sup> It is true that the workers in small firms can make use of the joint labor union system. But the cost in terms of both time and money in taking advantage of this union is substantial for their income. Workers in large firms can better withstand the litigation cost.

<sup>7</sup> Hatta [1996, pp. 494–495]. This was originally pointed out by Yoshida [1994, p. 162]. See also Noguchi [2010, p. 114] and Jo [2006].

by companies is increasing, a firm with lifetime employment will have a pyramid structure of age-based employees. We consider the situation where the annual growth rate of newly recruited young workers is higher than the market interest rate.

In this situation, a firm can borrow from its young workers by reducing their wage payments and reimburse the loans to the older workers by increasing their wage payments. We can show that both parties gain if the implicit interest rate (say,  $i$ ) of the intra-firm saving is between the steady growth rate (say,  $g$ ) of the employee size and the market rate (say,  $r$ ),<sup>8</sup> i.e., if  $r < i < g$ .

Firms can make it happen essentially because it keeps borrowing from the workers each year, with the borrowing carried over to the infinite future. This is how the Ponzi scheme works.<sup>9</sup>

We note that the strong regulations on borrowing (window regulation and regulated interest rates) that existed in Japan between the 1940s and early 1970s partly triggered the seniority-based wage system.<sup>10</sup> Companies, then under chronic financial difficulties owing to these borrowing regulations, implicitly borrowed from young workers in the form of low wages and returned this to them in the form of higher wages when the workers reach their 40s or 50s.

## 2. Incentives to Renege Long-term Employment Contracts

Suppose that the Ponzi scheme invokes a lifetime employment system for a firm. If the firm is an ongoing concern and reputation is important in attracting new workers, it will continue to offer the higher wage rate suitable for older workers even if there is no written agreement. However, with a financial crisis, the firm

---

<sup>8</sup>. Consider a steady growth economy, where employment is steadily growing at the rate  $g$ . Assume for simplicity that the firm pays back the loan from the workers by a lump sum exit payment at the time of retirement. Hence, the workers get lower wage rate than under the merit-based wage system when they are in their twenties and thirties, then earn the merit-based wage until retirement, and finally receives the exit payment that redeems the loan they gave when they are young. If the firm pays the exit payment as the sum of the wage payment and interest payment at the rate of  $g$ , the revenue from the savings in wage and the expense in the exit payment will exactly match. The firm will gain if the implicit interest rate is less than  $g$ .

<sup>9</sup> See the Appendix I for a more detailed discussion of the Ponzi scheme.

<sup>10</sup> Nakamura [1998].

may be motivated to rescind the implicit agreement of lifetime employment, effectively reneging the loan from the worker. Thus, prior written agreement on non-dismissal is necessary to protect workers in the Ponzi scheme.

### **3. The Doctrine of Abusiveness of Dismissals**

Once these external factors gave birth to the seniority-based wage system, many workers willingly accepted low wages when they were young while expecting that they would be employed for a lifetime under the seniority-based wage system. Even at the time of recession, many firms lived up to this expectation since such reputation would enable them to continue to hire high-quality workers. But with a financial crisis, for example, there were firms that dismissed their workers, being unable to meet the expectation. In this situation, some courts gratuitously started to invalidate dismissals, even where there were no contracts or agreements that explicitly committed firms to no-layoff or lifetime employment. Presumably, this was because the courts wanted to protect workers' expectations of lifetime employment by preventing the employer from breaking any implicit promise to pay higher wages later, to remunerate for lower wages earlier. The *doctrine of abusiveness of dismissal*, which honors this expectation, developed in Japan in light of this historical context.

During this period, other court rulings stated that workers without a no-dismissal contract should accept dismissal following the original Civil Code. If such rulings had prevailed, employers and employees who wanted a lifetime employment commitment would have explicitly stipulated a no-dismissal clause in their contracts. The decisive shift to the lifetime employment system came with a 1975 Supreme Court ruling which authorized the doctrine of abusiveness of dismissal, later codified in the Labor Standard Law in 2003.

### **4. Exit Payments**

In Japan, it is an established employment practice for a firm to pay a lump sum, "*taishoku kin*" or exit payment, to a regular worker at the time the worker leaves the firm at the mandatory retirement age or before. The Ponzi scheme can explain why most firms make the exit payment voluntarily. Indeed, the longer an

employee remains in a firm, the more advantageous the exit payment,<sup>11</sup> because the level of exit payment is roughly equal to one's monthly salary of the last month multiplied by the years of employment to the firm.

When explained in terms of the Ponzi scheme, therefore, the exit payment is a deferred payment to the advantage of both employees and employers.

## **5. Firm-specific Human Capital: Another Reason for Long-term Employment**

Thus far, we have shown that the Ponzi scheme can explain the emergence of seniority-based wage and exit payment systems in Japan. Nonetheless, other factors may have also contributed to establishing a lifetime employment system. One such possibility arises when the worker invests firm-specific human capital. Since the acquired skills are useless in other firms, the worker would like to have a long-term employment commitment from the firm so that the investment in the skill is eventually paid back in future wage.

If the firm is an ongoing concern and its reputation is important for attracting new workers, it will continue to offer a high wage rate appropriate to the acquired skills. However, as these skills may be useless in other firms, the firm will be motivated to exert monopsony power over the wage at the time of business crisis, if the long-term engagement is based only on a tacit understanding. Therefore, a prior written agreement is necessary to protect the worker.

A commonly made claim is that the investment in firm-specific human capital is the main cause of the lifetime employment system and seniority-based wage system. However, investment in firm-specific human capital cannot be the main reason for the widespread practice of a seniority-based wage system.

First, this theory cannot explain the spontaneous use of exit payments.

Second, this theory cannot explain the commonly observed fact that an older regular worker is earning far more than a non-regular worker who is doing the

---

<sup>11</sup> This implies that the longer the employment at a firm, the more advantageous it becomes in terms of exit payments, and that starting one's career at a company immediately after graduating from high school or college is a strategy for maximizing any future exit payment.

same job.

Third, this theory cannot explain the phenomenon that during the heyday of the seniority-wage system, wage continued to increase until the retirement age in most firms long after the workers have acquired almost all the necessary firm-specific skills.<sup>12</sup> Thus, the theory cannot explain why the wage rate is typically higher than productivity at a higher age.

Fourth, firm-specific human capital theory alone cannot explain why the lifetime employment system is more prevalent in Japan than in other developed countries. If investment in firm-specific human capital is characteristic of certain industries, it should be universal in those industries regardless of where they operate in the world.

Note that Ponzi scheme can explain all these phenomena.

The fact of the matter seems to be that once a Ponzi scheme triggers the lifetime employment system, the firms are motivated to allow their workers to invest in firm-specific human capital. In an economy with a flexible labor market, few workers have the incentive to learn such skills. However, in a firm where the lifetime employment system already operates, workers will be motivated to acquire such skills if the wage increases as a result. In this sense, the prevalence of accumulated firm-specific human capital in the lifetime employment system is a result of the lifetime employment system rather than its cause.

## **6. Incomplete Contract**

It is often claimed that the incompleteness of the contract can justify government intervention to guarantee long term contracts. After all, not everything can be written in the contracts, and unexpected circumstances will emerge. So guaranteeing a long term contract is necessary to protect workers, so the argument goes.

This argument can be used to explain why many firms in the US voluntarily adopt no-dismissal agreements and severance payments. But this argument

---

<sup>12</sup> In recent years, however, wage curve has started to slightly come down after age of 50. Also, the ratio of the exit payment to the lifetime wage income has been coming down. These phenomena seem to reflect erosion of the pre-conditions of the Ponzi scheme in recent years.



cannot support government intervention in the labor market that forces non-dismissal condition in every contract. Especially, it cannot support to disallow the parties to set the level of severance payment freely.

Introduction of a severance payment will greatly reduce the opportunity cost of being dismissed. If the severance payment is set, it will make workers more mobile, and the job placement market will develop, which will then greatly reduce the opportunity cost of being dismissed.<sup>13</sup> Then, a worker can quit anytime without much cost. At the same time the working condition of each firm will become more transparent as the job placement market develops. Introduction of severance payment itself reduces the relevance of the incomplete contracts.

We should address the issue of incomplete contracts through policy tools directly aimed at the issue, like allowing the severance payment as a dismissal condition, rather than through distorting the market, which gives rise to various side effects including damages against the very people whom the intervention intends to help<sup>14</sup>.

## **7. Remarks on the Lifetime Employment System**

A few remarks on lifetime employment are in order.

1. The basic problem with the current employment system is that even if a firm dismisses a worker in compliance with the employment agreement, still court can rule that the dismissal was abusive. Thus, a law should stipulate that dismissal is valid if it is based on a prior agreement or contract. Then, the court cannot rule that such a dismissal is abusive. The role of the court then is to determine whether a particular dismissal satisfies the dismissal condition stipulated in the agreement, rather than to judge whether or not the agreement itself is

---

<sup>13</sup> See Yashiro [2018, Section 5].

<sup>14</sup> Moreover, in the IT age, information on employment can be disseminated far more easily than it used to be. After all, house- and car-sharing services have been working well in many countries, assisted by the availability of widespread reputation information through IT.

abusive.<sup>15</sup>

2. If the Japanese Law made the stipulation as above, many firms would adopt a merit-based wage system, and such companies would have invested in training general rather than firm-specific skills<sup>16</sup>.

Also, many firms would adopt a seniority-based wage system by making lifetime employment commitment explicit in private contracts as in the US. The most effective way to realize spontaneous contracts in a seniority-based wage system is then to uphold the validity of dismissal based on explicit agreements or contracts.

3. Even if there were no such legal stipulation as stated in 1, the Supreme court could have effectively attained a similar situation. In 1975, the Supreme Court missed the opportunity to strictly define the range of abusiveness of the employer by stating most dismissals based on explicitly written agreements should be regarded non-abusive, overturning the previous rulings by lower courts. Noting that the court's unpredictable judgment had caused so much social misery, as exemplified by Ice Age Cohorts, the Court should have refrained from the ruling of abusiveness when an explicit written agreement of lifetime employment had not been made. Perhaps the court was not in a position of denying its power of judging the abusiveness in the framework of the Civil Code, but it could have minimized the social cost of unpredictable rulings by defining the types of abusive dismissals far more strictly than the 1975 ruling.

It was particularly unfortunate that the Supreme Court missed the opportunity in 1975 when all the pre-conditions for the Ponzi scheme, which had underpinned the seniority wage system were beginning to erode.

4. The reason the seniority wage system is now crumbling in many

---

<sup>15</sup> This proposal has been made by Ouchi [2013, pp.175-178].

<sup>16</sup> As the system of lifetime employment seniority became mandatory in practice, a wide range of Japanese firms was obliged to develop firm-specific skills. As a result, lifetime employment became even more difficult to resolve.

industries in Japan is that the Ponzi scheme cannot function when the rate of employment growth over the long term is not expected to be high.

## Part 2: Severance Payments

### —Welfare Economics Justification for Severance Payments

#### *I. Types of Severance Payment*

To help reduce the cost of dismissal settlement, many scholars have proposed the introduction of statutory severance payment in Japan. In Part 2, we consider the types of severance payment that are appropriate for introduction in Japan. Table 1 classifies some of the representative severance payment system already in place.

Table 1. Types of Severance Payment

	Explanation	Dismissal by contract	Dismissal with good cause	Dismissal without good cause
<b>Contractual</b>	The level is freely determined by contract or by agreement	① US		
<b>Noncontractual</b>	The level is predetermined by statute or by convention		② Taiwan (Old System) ③ Taiwan (New System)	④ Germany

In the US, the severance payment is contractual in that the parties concerned set its level in each contract or agreement through employment handbooks, just as with other conditions for dismissal. Parsons and Feng [2006, p. 4] state that contractual severance payment plans cover approximately 26% of the full-time labor force in the US.

In Taiwan, severance payments are statutory under both the Old and New Pension Schemes, as discussed elsewhere in this volume. Taiwan has “just cause” for dismissal and severance payment is only to those dismissed in compliance with this just cause. The level of the payment depends on both the length of service and the wage level, and dismissals that do not satisfy just cause must go through a long court process before any settlement.

In contrast, in Germany, firms make severance payments to workers if the

dismissal does not satisfy just cause. Court-mediated settlements determine the amount, which then sets the level standardized by convention.

In Japan, a list of statutory *just causes* for dismissal does exist, although they are rather vaguely stated. When the court rules that dismissal does not satisfy just cause, monetary settlements are made through Alternative Dispute Resolution (ADR) and other processes of reconciliation, which do not involve a judge. There is little predictability about the level of cash payments for settling a dismissal, as the level varies from one case to another.<sup>17</sup>

## ***II. The rationale for Severance Payments***

In the following, we examine various justifications for severance payments.

### **1. As Dismissal Insurance**

Contractual severance payment in the US can be justified as *dismissal insurance* provided by the employer against the income losses of the dismissed. Risk-averse employees would be willing to purchase insurance against unexpected income losses that result from dismissal. In contrast, risk-neutral employers would be willing to supply such insurance by furnishing severance payment (in lieu of delivering an insurance benefit) and by lowering regular wages (in lieu of receiving insurance premiums.)

Employees need dismissal insurance that provides two services, to:

- (1) cover necessary income during the job search period, and
- (2) compensate for any unexpected loss of income.

Employers or private insurance companies cannot cover insurance of type (1), as employees would have an incentive to prolong the job search period, invoking moral hazard. Therefore, many countries publicly provide

---

<sup>17</sup> See Section 5 of Yashiro [2018] and Ouchi [2018].

unemployment insurance instead of leaving it to the private sector. In a country where the government supplies unemployment insurance, providing insurance of type (1) is not a function of the severance payment<sup>18</sup>.

Insurance of type (2) does not cause this moral hazard, and hence needs no public provision; a private severance payment can provide the insurance of type (2).

The loss that dismissed workers face may vary greatly, depending upon the company where the employee works. If a worker can acquire general skills at a firm, he will not lose wage much by switching to a new firm, as these skills are marketable. Thus, he would prefer a higher wage than a higher severance payment. On the other hand, if a worker has only been able to acquire firm-specific skills, the worker's skills are not useful to another firm. Thus, the wage will fall by switching to a new firm, causing a large opportunity loss to the worker from the switch. The worker would prefer a higher severance payment than a higher wage. This implies that the privately negotiated severance payment schedule at the time of the employment contract should vary depending upon the kind of human capital accumulation offered by the firm.

Risk preferences can also vary from worker to worker. Thus, workers will find it beneficial to face the option of diverse combinations of severance payments and wage levels, like "high severance payment and low wages" or "low severance payment and high wages." In other words, firms can attract able workers by offering a high level of severance payment rather than a high wage.

On the other hand, firms' risk preferences are also diverse. It would, therefore, be socially efficient for different firms to present different combinations of severance payments and salaries.

We should note that severance payments, unlike unemployment insurance benefits, are made regardless of whether the worker remains unemployed or finds a new job. Thus, severance payment does not possess the moral hazard

---

<sup>18</sup> Public unemployment insurance could cause another moral hazard to the employer to dismiss excessively because the employer does not face the financial cost of the unemployment insurance benefit payment it entails. This moral hazard can be prevented by designing the unemployment insurance premium appropriately.

effect of giving an incentive to dismissed workers to have an excessive search period, as with an unemployment insurance benefit. Hence, severance payment as dismissal insurance need not be statutory and can be provided in the private sector alone. The US severance payment system provided by agreement serves exactly this purpose.

### **2-a. As a Substitute for Public Unemployment Insurance**

The statutory severance payment in Taiwan under the Old Pension Scheme can be justified as a substitute for public unemployment insurance. Before 2002, Taiwan did not have a public unemployment insurance system. This implies that before 2002, dismissed workers did not receive an income during their job search. In this situation, the statutory severance payment was a necessary substitute for public unemployment insurance, i.e., the type (1) role of dismissal insurance, which supports the job search period. In Taiwan, public unemployment insurance became available for all dismissed workers in 2002; hence, the severance payment lost its justification as a substitute for unemployment insurance benefits, and the level of severance payment was reduced accordingly in 2005.<sup>19</sup>

### **2-b. As a Substitute for a Public Pension**

The statutory severance payment in Taiwan under the Old Pension Scheme can also be justified as a substitute for a universal public pension. From the viewpoint of welfare economics, a public pension has two purposes. The first is to prevent moral hazard in the welfare system. In an economy with a welfare system, workers may be motivated to make zero savings to qualify for welfare benefits to finance their retirement. To prevent this moral hazard, the government is justified to force savings either directly or indirectly on all employees, in the form of a contribution to the public pension.

The second is to avoid the adverse selection that private provision of an annuity would entail. The market cannot provide an efficient level of annuity that

---

<sup>19</sup> According Li [2018], Professor Huang [1991] pointed out that severance pay provided "...certain protection until they (dismissed workers) have found a new job." This theory seems to accord with our claim that the severance payment under Taiwan's Old Pension Scheme served as a substitute for unemployment insurance.

pays benefits until death because those who expect to live long, tend to join the annuity, while those who expect a shorter life would tend not to join, causing their exodus from the annuity. This would make the premium extremely high, causing a further exodus of those with the expectation of a short life from the private pension. We can avoid this adverse selection by obligating all employees to join a publicly provided annuity. In sum, the public provision of a lump-sum pension at the time of retirement can protect the welfare system from moral hazard, while the public provision of an annuity can prevent both moral hazard and adverse selection in the pension.

In Taiwan, a public pension was only available to a small percentage of workers up until 2005. Until then, the public pension was a lump-sum payment at the time of retirement and not an annuity. This pension, therefore, served the first aim of a public pension as detailed above. Besides, under the Old Pension Scheme before 2005, only those who did not qualify for pension benefits were qualified to receive the statutory severance payment. The statutory severance payment in Taiwan under the Old Pension Scheme was a substitute for the part of a universal public pension that was not an annuity.<sup>20</sup> Its statutory level was calculated as:

$$\text{Working years} \times \text{Monthly income.} \quad (1)$$

### **3. As a Device to Internalize the External Social Cost of Dismissal**

In Taiwan, public unemployment insurance and a public pension in, the form of annuity became available to all dismissed workers in 2005. Hence, the severance payment as a possible substitute for unemployment insurance benefit and annuity, lost justification. As a result, the level of unemployment insurance

---

<sup>20</sup> According to Li [2018], Professor Liu [1986a-f] justified the severance payment as a differed wage. A differed wage implies raising the wage as workers become older, at the cost of reducing wages when workers are young. This could be done without government intervention if both employers and employees agree with such an arrangement. For the government to force employers and employee to have this arrangement, there must be a reason. From the economics point of view, however, using a statutory severance payment as a substitute for the public pension may be justified.



substantially fell in 2005 to the level

$$\textit{Working years} \times \textit{Monthly income} \times 0.5, \quad (2)$$

up to a maximum payout of

$$\textit{Monthly income} \times 6. \quad (3)$$

However, the new scheme did not abolish the statutory severance payment. What then is the justification for the remaining statutory severance payment?

One reason is that the statutory severance payment under the New Pension Scheme corrects an imperfection in unemployment insurance in Taiwan (which became compulsory after 2005). In an economy where public unemployment insurance exists, dismissal by a firm entails an additional unemployment insurance payment, imposing an external cost on government.

However, there are cases where firms can avoid dismissal by bearing the small cost of retraining or job reallocation. Even in such cases, the firm will dismiss the worker if it does not have to bear the external cost. If the marginal cost of the unemployment insurance benefit payment to the firm is less than the additional cost of avoiding additional dismissal, firms will be induced to dismiss excessively from the welfare economics viewpoint, causing moral hazard.<sup>21</sup>

In this situation, making insurance premiums dependent on the number of dismissals by the company, as in the US, would suppress excessive dismissal and reduce the level of this moral hazard by employers.

However, in Taiwan, as in Japan, public unemployment insurance premiums are not dependent on the number of dismissals, thereby invoking this moral hazard. Since statutory payments have the effect of discouraging dismissals, they can be viewed as a substitute for raising the unemployment insurance premium for frequent dismissals.

This can be one justification for the remaining statutory severance payment

---

<sup>21</sup> See footnote 19.

system under the New Pension Scheme in Taiwan.

The difference between a well-designed premium structure for unemployment insurance and severance payments for eliminating excessive dismissal is that, in the case of the severance payment, dismissed workers receive income in addition to unemployment benefit. If this additional payment to workers were converted to reduce the general premium for unemployment insurance, it would attain a more efficient resources allocation. Thus, using severance payments for this purpose is a second-best solution.

Eventually, there should be reforms to unemployment insurance to prevent firms from dismissing workers excessively. For the present, a statutory severance payment can perform that role.

#### **4. As a Transitional Measure to a Vacancy Decontrol**

In countries where private agreements on severance payment are introduced as a result of vacancy decontrol, it may be useful for the government to set the minimum level of severance payment for all the new contracts, as a transitional measure.

This transitional measure was called the government-assisted vacancy decontrol. The payment of the minimum level of severance payment under this decontrol has three purposes.

First, it covers the external marginal cost of dismissal on unemployment insurance system.

Second, making severance payment statutory at the start of vacancy decontrol facilitates the government's establishment of a system securing the disbursement of severance payment even at a time of the firm's financial difficulty. The first choice for this purpose is to require the firms to establish a fund for severance payment with a minimum balance required. Taiwan has taken this approach.<sup>22</sup> Standardizing statutory severance payment will facilitate the establishment of this type of system. Another choice is to foster the insurance market for firms to prepare for disbursement of the severance payment. When

---

<sup>22</sup> See Chang [2018, Section 1-3, Footnote 31, and Appendix 3].

severance payments are statutory, a sufficient size of the customers will be supplied for the insurance market to jump-start the market. Once that market is created, even after severance payment becomes voluntary, the market can be self-sustaining. The government should require the firm either to establish a fund or otherwise to join insurance. To facilitate the establishment of such a system, introducing a uniform statutory severance payment will be helpful even if its level is set low.

Third, this removes the possibility that the workers unfamiliar with the severance-payment agreement may inadvertently fail to notice this aspect of the employment agreement.

The 2005 reforms of the Labor Standard Act and the Pension Act in Taiwan was government-assisted vacancy decontrol. In Taiwan, dismissed workers who worked for 20 years receive the equivalent of three months of wages as an unemployment insurance benefit. Therefore, to internalize the external (social) cost of dismissal, the maximum payment employers need to pay would be three months. This is smaller than the statutory level of severance payment, which is equivalent to six months of wages. This gap can be justified as a transitional measure by the second and the third purposes above.

As the provision of severance payment by agreement or contract becomes more common, the statutory level can be reduced.

## **5. As an Alternative to the JRR**

The 2004 German reform allowed replacement of the job-restoration requirement (JRR) with a court-mediated severance payment.

German labor law stipulates just cause for dismissals, such that where dismissals do not satisfy these causes, the court orders restoration to the original position. However, after the 2004 Schröder reform, it has become common for a court-mitigated settlement to provide a monetary settlement as an alternative to the job restoration order. According to Yamamoto [2018], 90% of dismissal disputes in Germany end in monetary compensation through court-mitigated settlements.

Although there is no legal rule on the amount of monetary compensation in such settlements, it has been a convention to apply the following formula

$$\text{Working years} \times \text{Monthly income} \times 0.5. \quad (4)$$

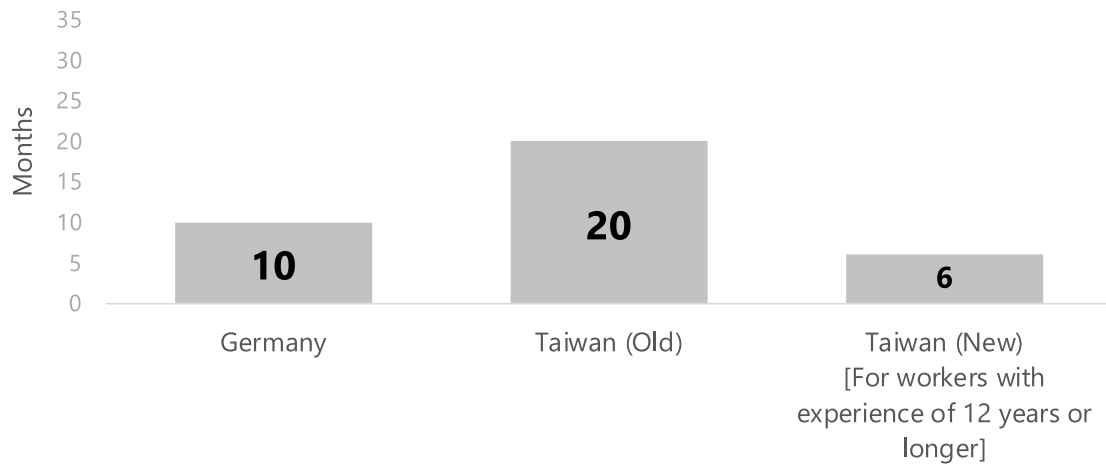
While there have been departures from this rule at times, most cases settle near this reference level. Hence, at least in Germany, the cost of the monetary settlement is predictable. Therefore, for many firms, it is far less costly to pay the severance payment than to contest the claim of no just cause and proceed with a lengthy litigation process.

In Germany, most firms have accepted severance payments rather than seek court decisions of no abuse. Hence, setting a statutory level for severance payments would expedite the termination procedure.

### ***III. International Comparison of the Statutory Severance Payment as Monthly Income***

At the outset, we should note that the severance payment in Germany is compensation for the violation of just cause, while the severance payment in Taiwan is for dismissals in compliance with just cause. This seems to reflect the fact that just cause in Taiwan has been far more transparent and practical than the German counterpart. Indeed, in Taiwan, a large number of dismissals satisfy just cause. The following graph summarizes the levels of statutory severance payment in Germany and those made under the old and New Pension Scheme in Taiwan.

Figure 1. Severance Payment as Monthly Income



As shown, the amount of severance payment in Taiwan under the Old Pension Scheme is much higher than the monetary compensation in Germany. This is only natural, given the severance payment under the Old Pension Scheme in Taiwan was to compensate for the lack of a pension and unemployment insurance. However, the Taiwan level under the New Pension Scheme is much less than the one under the Old Scheme, because unemployment insurance and the public pension are already available. Now, workers have the choice of either staying with the Old Pension Scheme or joining the New Pension Scheme, which makes the reform vacancy decontrol. Note that the German level is higher than the Taiwan level under the New Scheme because the German severance payment compensates for existing JRR.

#### ***IV. Welfare Economics of a Severance Payment: Should it be a Choice or a Mandate?***

Any severance payment is in principle financed by a reduction in the wage rate. Therefore, a statutory severance payment implicitly forces employers to reduce the wage rate to finance the severance payment, whereas the parties in a contractual severance payment agree upon the level of wage reduction and the

severance payment<sup>23</sup>. From the viewpoint of welfare economics, any market intervention needs to be justified on the grounds of market failure and income redistribution.<sup>24</sup> The public provision of unemployment insurance and pension are market interventions. However, as discussed, their public provision can be justified on the grounds of information asymmetry, a type of market failure. A statutory severance payment is also a clear market intervention in that individual contracts can include such negotiations. A severance payment can also be justified if it makes up for the lack of public unemployment insurance or public pension. That is indeed the case of Taiwan under the Old Pension Scheme.

Accordingly, in a country with public pensions and efficient public unemployment insurance, the rationale for statutory severance payments is lost. Nonetheless, if the public unemployment insurance has a loophole invoking moral hazard, a statutory severance payment may be justifiable means to close this loophole as a second-best solution.<sup>25</sup> Also, if the cost in this economy is high, a statutory severance payment can be useful in that neither employers nor employees can rely on private contracts or agreements, at least without significant cost of enforcement. The provision of an inexpensive judicial system for basic contracts that oversees employment conditions for the working poor should be seen as a public good or an essential facility. Market intervention by forcing firms to pay statutory severance payments could then be an appropriate measure to counter the lack of public goods, i.e., market failure.

We readily observe that the US has both a public pension and an efficient system of public unemployment insurance. In particular, the design of this unemployment insurance is to remove the moral hazard of excessive dismissals by making the premium dependent on the frequency of dismissals by the firm.

---

<sup>23</sup> The argument in defense of agreement-based statutory severance payment in the line of Posner [2003] is that if statutory severance payment is imposed externally for the purpose of job protection, wages would be lowered to compensate for the higher job security, and the wage decrease would be worth less to the workers than the employment security if they did not choose a positive level of the severance payment themselves. Thus, such an external imposition of statutory severance payment will harm workers.

<sup>24</sup> See Hatta [2006], for example.

<sup>25</sup> This is not the best solution as in this case, there is no reason to reform the economy.

Furthermore, litigation cost in the US is relatively low. In this situation, employees and employers can privately negotiate the level of severance payment, if any. Workers can then easily choose from a variety of combinations of severance payment and wage level, and both employers and employees can find a proper combination of sharing the cost of unexpected income reduction from the dismissal.

In contrast, many European countries have chosen to set a socially high dismissal settlement cost without any clear rationale that draws on welfare economics.<sup>26</sup> When the cost of dismissal settlement is in the form of a JRR, a severance payment in lieu of that requirement may be an obvious improvement in the sense that it will benefit both employers and employees. Nevertheless, we should regard it as a halfway house towards a market-determined severance payment system.

---

<sup>26</sup> Some argue that a statutory severance payment that makes dismissal difficult is useful for motivating workers to undertake firm-specific human capital investment. However, a firm could spontaneously choose to assure job security because that is also to the benefit of the firm.

## **Part 3: Reform of the Employment System in Japan and Severance Payments**

As discussed, the current Japanese employment system imposes a high cost on dismissal, and the existing employment system involves various shortcomings. Major reforms to solve this problems are in order.<sup>27</sup>

### ***I. As Compensation for JRR for Existing Contracts***

#### **1. Settlements**

The first reform is the introduction of statutory severance payment for existing contracts; as a substitute for the JRR, the court imposes when it rules that the dismissal of a worker did not satisfy just cause. According to Article 16 of the Japanese Labor Contract Act, dismissal should be invalid if the court decides that it was abusive. This implies that in the process of the dismissal dispute, the employer has no option but to terminate an employment relationship by making a severance payment. Thus, the employer is compelled to accept a continuation of the relationship. Consequently, the lack of a severance payment system in Japan makes the settlement cost for termination unnecessarily high.

In practice, reconciliation processes determine the level of severance payment in Japan. This poses two problems. First, the level of severance payment varies from case to case. Therefore, firms cannot predict the monetary settlement they are expected to make. Second, the time and monetary cost of obtaining a court-mediated settlement of monetary compensation are substantial. This is mainly because an employee can appeal to the court only about job restoration, and only after a ruling that the dismissal is invalid, after which the negotiation on monetary compensation can commence.

---

<sup>27</sup> Some scholars argue the system's main merit of protecting worker investment in firm-specific skills outweighs its cost. However, each firm should be free to conclude private contracts reflecting the differing degrees of employment security. There is no reason to impose a very high termination cost by statute.



Setting the monetary compensation formula into law would simplify the current two-step approach to just one so that a judge who concludes that dismissal is invalid can decide the amount of monetary compensation, based on a formula established by law. Such a reform allows firms to readily predict the amount of severance payment required so that from the outset they will be more willing to accept the invalidity of the dismissal under the current law, which will expedite court procedure. As a result, setting a standard monetary compensation rule for existing contracts is beneficial to both employers and employees, if the level of compensation is appropriate. For its part, severance payments for existing contracts must be statutory, as their purpose is to widen the option for termination settlement in a framework which requires the penalization of *abusive* dismissal.

In certain industries, however, a nationally uniform statutory level may not be satisfactory to either employer or employee. In that case, the prior written agreement can be made to set the extra amount of severance payment in addition to the statutory level. The statutory level would prevail, however, if no agreement on the additional severance payment could be regarded by the parties concerned.

## **2. The Level of Severance Payment for Existing Contracts**

Let us now consider the appropriate level of severance payments for existing contracts as compensation for job restoration. As a model case, consider a person aged 45 with an annual salary of 8.0 million yen (including bonuses), who has worked in a large company in Japan for 20 years. (Assuming that his starting salary was 3.0 million yen including bonuses, his average annual salary is 8.0 million yen, which means that his average monthly salary is 500,000 yen.)

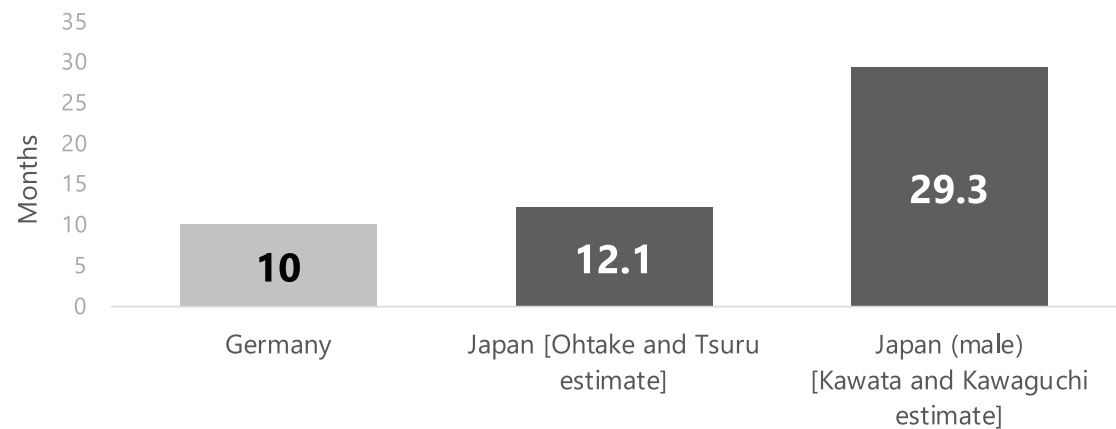
In Japan, monetary compensation is determined through negotiations between an employer and the employee. However, while there is no specific formula for monetary compensations in Japanese labor law as in European countries, accumulated case law over the years and the agreed-upon level of severance payment can be explained by duration of the work at that firm and the wage level.

One possible way to determine the level of compensation is to collect data on actual settlements in Japan and then attempt to explain it using wages and

length of service. Ohtake and Tsuru [2016] performed such an econometric analysis for the *Labor Tribunal* in 2013, using 452 samples from the Japan Institute for Labour Policy and Training database. The findings indicate that monetary compensation, in terms of monthly wages, closely relates to the years of service in a firm. For instance, the predicted compensation for regular workers is based on an equation of a minimum of 5.5 months of wages plus 0.33 months of wages for every year of service, i.e., 12.1 months' salary for an employee who has worked for 20 years.<sup>28</sup>

Based on this figure, we would like to propose the severance payment for compensation for a model worker who is currently working to be one year's wage. After all, the Ohtake–Tsuru figure represents a typical court-mediated level of severance payment in Japan, and it is likely to be acceptable to the parties concerned.

Figure 2. Severance payments to compensate for the JRR in Germany and Japan



The Ohtake and Tsuru estimate for Japan is very close to the actual payments in Germany, as is illustrated in Figure 2. This is because the calculation for both represents compensation for the JRR. The major difference is that in Japan, there is much more variation in court-mediated levels of settlement, the

---

<sup>28</sup> Ohtake and Tsuru [2016, p. 4]. Generally, the amount of monetary compensation is smaller for nonregular workers, being 3.4 months plus 0.2 months for every year of service, or 5.4 months' salary in the equivalent case. However, there could be bias in the estimated coefficient for years of service in that the monthly salary by itself becomes higher with longer years of service.

level is largely unpredictable, and there is often a long delay before any ruling.

Another way to determine the level of compensation is to compensate for the maximum opportunity loss of dismissal to workers. Kawata and Kawaguchi [2018] calculated the amount of monetary compensation based on the “full compensation rule.” They estimated the amount of compensation to be 29.3 months in the case of a male worker.<sup>29</sup> This estimate is very high compared with the Ohtake and Tsuru [2018] estimate, as illustrated in Figure 2. This is presumably because Kawata and Kawaguchi assumed that workers could continue to disguise low productivity with high productivity in the firm from which they were dismissed.

### **3. Three Principles for Severance Payment and Exit Payment**

In Japan, it is an established practice that a dismissed worker receives an exit payment. The question arises whether the severance payment should be paid in addition to the exit payment or the severance payment should contain the current exit payment.

Regarding this issue, note that in Japan it is customary to give the exit payment even to a worker who resigns, although the amount for the resigned is slightly lower.

Since the exit payment is a deferred payment in the Ponzi scheme, the purpose of the exit payment is quite different from the purpose of the severance payment as compensation for the JRR. So, the logical solution would be that the severance payment is paid in addition to the exit payment, or to the level of exit payment paid for the worker who resigns, to be exact.

The difference between the exit payment paid to the dismissed and the one paid to the resigned may be called the “dismissal premium.” It may be viewed as the compensation that the firm pays the dismissed worker for the loss of being unexpectedly dismissed under the current set up. Hence, this dismissal premium will be a part of the new severance payment.

The following principles may simplify the role of the severance payment and

---

<sup>29</sup> Kawata and Kawaguchi [2018, p. 261].

exit payment.

1. The firms can set the level of an exit payment at any level it wishes, under the constraint that the level for the resigned and the one for the dismissal must be equal.
2. For the dismissed, the statutory level will be paid on top of the exit payment.
3. The firm is free to add to put an additional amount of severance payment on top of the statutory level if both firm and the employee agree. If they don't, the statutory level will prevail.

Thus, an employer pays a higher exit payment for a dismissed worker than for a resigned. This gap is the *dismissal premium* over resignation (or simply, the dismissal premium). Currently, the dismissal premium for our model worker is a wage rate of 1.2 months (753,171 yen), as the exit payment is 8.1 months (5,379,795 yen) for dismissal and 6.9 months (4,626,624 yen) for resignation. The small difference scarcely serves as a deterrent for dismissal.

Of course, the additional severance payment must be financed in some way. If this is financed by a reduction in the growth rate of wages, even the workers employed after vacancy decontrol have to share some of the burdens of the additional severance payment, which is paid only for the existing workers.

If different wage schedules are allowed between the existing and new contracts, however, the wage rate schedule for the new contract can be blocked from the influence of the severance payment system for the existing contracts, and the problem may be avoided. The principle of the “equal pay for the equal work” should be applied to the entire wage schedule package consisting of exit payments, severance payments, risk, and seniority, rather than the wage rate at a given moment.

## ***II. New Contracts under Government-assisted Vacancy Decontrol***

### **1. Two Functions of the Severance Payment in Government-assisted Vacancy Decontrol**

The second reform is the introduction of *government-assisted* vacancy decontrol applicable to new labor contracts for recently vacated or newly created positions. In this reform, the government will set a minimum statutory level of standardized severance payment while allowing a firm to set any level of the severance payment above the official minimum level when it employs a new worker.

As we discussed in Part 2: II–3 and 4, the statutory severance payment under government-assisted vacancy decontrol serves two purposes. The first is as a device to internalize the external social cost of dismissal on unemployment insurance. The second is as a transitional measure to vacancy decontrol.

Since statutory severance payment discourages dismissals, this system serves a similar function as the dismissal-dependent premiums in a well-designed public insurance premium.

Also, a minimum statutory severance payment will remove the possibility that the workers unfamiliar with the severance-payment agreement may inadvertently fail to notice this aspect of the employment agreement.

### **2. The Level of Severance Payment under the Government-assisted Vacancy Decontrol**

Let us consider the appropriate levels of severance payment for new contracts if Japan was to carry out government-assisted vacancy decontrol. It is reasonable to apply the Three Principles of Exit Payment and Severance Payment even to this case.

We propose to make the statutory severance payment for the new contract for a model worker to be six months of wage. The reasons are as follows:

First, the level for the statutory severance payment for the new contracts can be set flexibly within a bound. The employers and employees in the new contracts

are free to set the severance payment on top of the statutory level. Hence if the statutory level is too low, the parties can put additional severance payment. If the statutory level is set too high, both parties will reduce exit payment. After all deferred payment in the form of exit payment has no role in the contract where the Ponzi scheme does not apply. The only bound for the statutory severance payment in Japan is that it should not be less than the dismissal's external social cost on the public unemployment insurance.

Second, the proposed level (six months) is equal to the external cost of dismissal. The maximum unemployment insurance benefit that our model worker receives in Japan is six months of wages. This is the maximum level of the charge required on the firm for the elimination of excessive dismissals in the system of unemployment insurance. Our proposed level at least cover this level.

Third, the level of severance payment under New Pension Scheme in Taiwan is also six months of wage. This is a well-tested level in Taiwan for a transitional measure that allows employers and employees to get used to the concept of severance payment.

In case of Japan, moreover, exit payment is paid on top of this severance payment, so the total termination allowance a dismissed worker receives is much higher than that in Taiwan.

A few remarks are in order.

First, this level will be sufficient to create a new insurance market for firms to prepare for the expense of severance payment. Thus the third purpose of the statutory severance payment under the government assisted vacancy decontrol is attained.

Second, once the unemployment insurance system is reformed so as to impose a penalty sufficient for excessive dismissals, the level of the statutory severance payment may be reduced to give room to increase the wage rate.

If very few voluntary agreements are made to add on the statutory level by the time of the reform of the unemployment insurance system, the statutory level should be gradually reduced. If, say one third or one-half of the parties spontaneously choose to add on the statutory level. The reduction could be

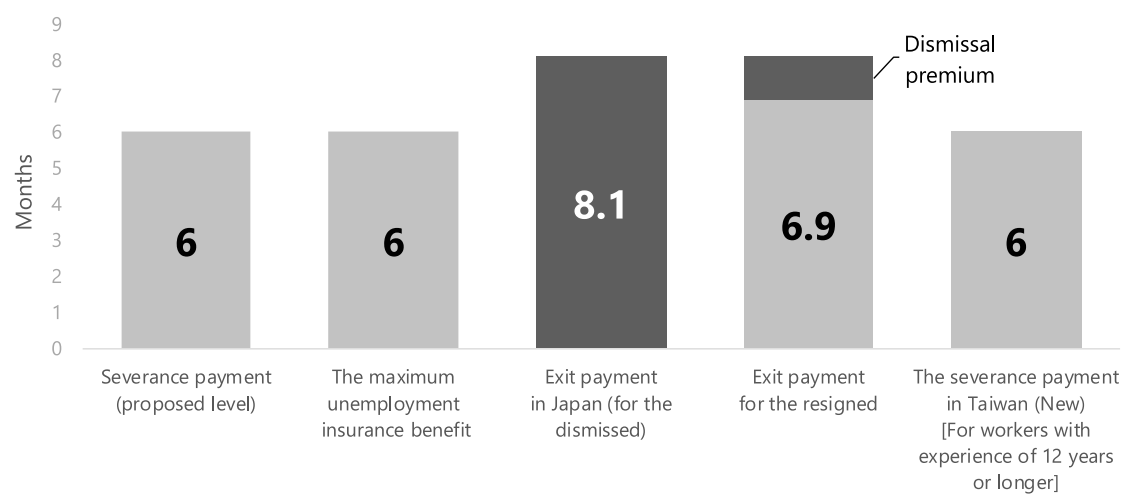
stopped there.

This level can be later transformed into a default level from which parties can get out if both the employer and employee agree when the government-assisted vacancy decontrol is elevated to complete vacancy decontrol<sup>30</sup>. So as a first measure, six months seems to be a reasonable figure.

Third, this number (6 months) happens to be about the half of the proposed statutory severance payment for the existing contracts (12.1 months).

Finally, the (voluntary) level of exit payment in Japan for a dismissed worker is 8.1 months of wages in our model case.<sup>31</sup> This is much larger than the proposed level of the statutory severance payment for the new contract. Hence, by transforming the existing exit payment, Japanese employers on average can afford to pay the new statutory severance payment. But exit payment will be drastically reduced as a result of the introduction of the government-assisted vacancy decontrol.

Figure 3. Severance payments for the new contract for our model worker



### 3. Just Cause

A remark is in order on just cause. Germany has legal dismissal on the basis

<sup>30</sup> See Section III of the present Part.

<sup>31</sup> However, the level of exit payment for *workers who have resigned* is only seven months of wages.

of just cause, but firms there are often willing to accept that dismissal does not satisfy just cause and instead provide a severance payment, thereby bypassing the expected lengthy litigation process. This implies that just cause is in practice idle. Thus, just cause is not necessary for introducing a severance payment system in place of a JRR or government-assisted vacancy decontrol.

In contrast, in Taiwan, as Shiu and Chien [2018] point out, only dismissals that pass the court's test of just cause are eligible for severance payments. In other words, workers can sue the company to pay more than the usual severance payment if they believe that their dismissals do not satisfy "just cause." It appears that this may reflect the tradition of the Old Pension System, with a very heavy level of severance payment designed to compensate for the lack of unemployment insurance and pension systems. Taiwan needed to be extremely careful with dismissal in those days. In view of expediting the litigation process, however, the German approach of bypassing just cause may be appropriate in Japan.

### ***III. New Contracts under Complete Vacancy Decontrol***

The introduction of *complete* vacancy decontrol allows a firm to set the amount of severance payment and any other dismissal conditions when employing a new worker. If this reform was to proceed, severance payments need no longer be statutory.

After an economy has experienced government-assisted decontrol for a certain length of time, complete vacancy decontrol without a statutory severance payment could be introduced.

#### **1. A Default Level of Severance Payment**

Even then, it may make sense to set a default level of severance payment that a firm must accept unless it makes an explicit agreement with its workers to set a different level, including no payment.

Some states in the US have introduced vacancy decontrol similar to the one described above. In the US, employers have always had the option of choosing



at-will employment and just-cause employment. The procedure for this option, however, has changed over the years.

Before the 1960s, employment-at-will with a zero-severance payment was the default, though the firm had a choice of making an explicit agreement with workers about just cause for dismissal, including the level of the severance payment. In other words, if a firm did not opt for just-cause employment, it was automatically considered to have opted for at-will employment.

However, the situation changed in the 1960s. The current situation is illustrated in Figure 4. First, certain dismissals, such as discrimination, are determined as illegal by the Federal Laws now. Second, certain exceptions are set by States.<sup>32</sup> Third, unless a firm explicitly declares that it has the policy of “at-will employment” or “just-cause employment” in its employment handbook, it must obey the default version “just-cause employment” and pay the severance payment amount set by the court.<sup>33</sup> In this way, many firms do not have to go to the trouble of including severance payment clauses in their contracts. This would also protect workers in small firms, as they may otherwise not note the need for including severance payment provisions.

Note that the basic argument in defense of at-will employment is that if just-cause protection was imposed externally, wages would be lowered to compensate for the higher job security, and that if employees did not choose just cause protection, the wage decrease would be worth less to the workers than the employment security. Thus, such an external imposition of just-cause policies will harm workers.<sup>34</sup> Note also that Hyde [2003] has identified at-will employment as a reason for the success of Silicon Valley as an entrepreneur-friendly environment.

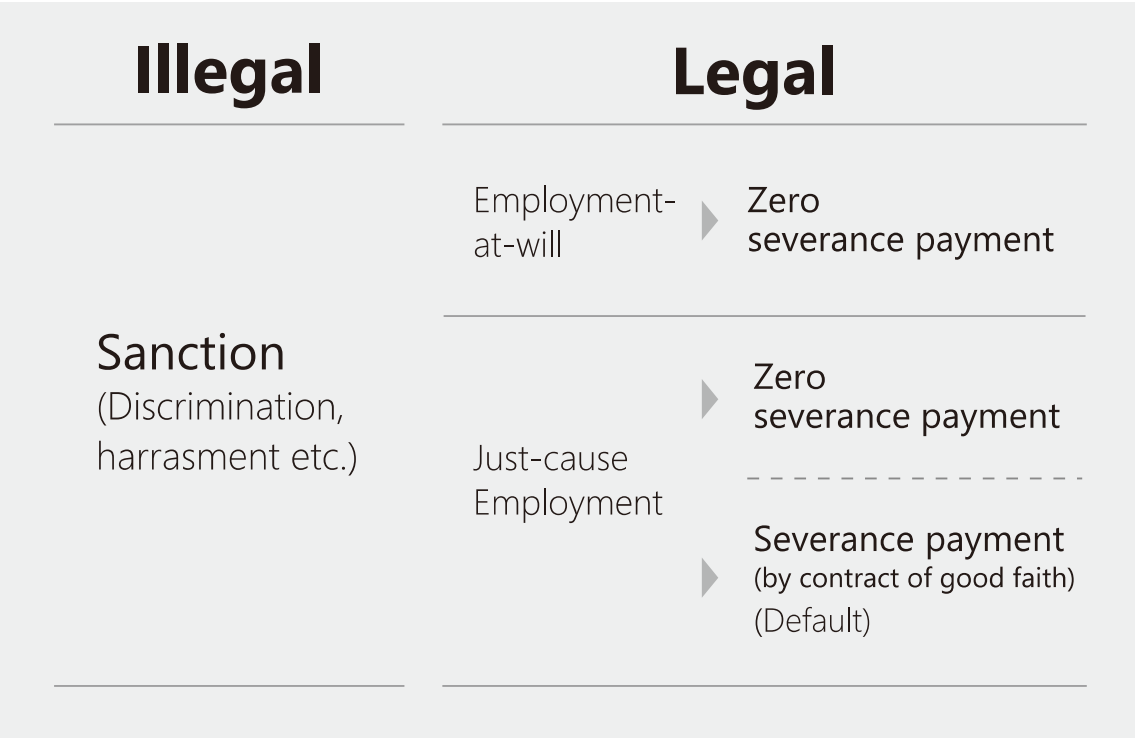
---

<sup>32</sup> National Conference of State Legislature [2008].

<sup>33</sup> Holzschu [2016].

<sup>34</sup> Posner [2003].

Figure 4. Types of Monetary Settlement in the US Severance at Present



2. Litigation Cost

One possible concern above the complete vacancy decontrol is that letting the private party decided the level of severance payment may penalize the employees in small firms. As we know, there is a disparity in the monetary compensation available to employees who can appeal to the court and those who cannot. Since judicial procedures usually take a long time and are costly, most employees in small firms will have a difficult time appealing to the court, unlike those in large firms.

Once the court starts to honor contracts with severance payment as terms for dismissal, however, this by itself will drastically reduce the litigation cost. It is much easier for the court to determine whether the firm paid a severance payment than to determine whether the dismissal was abusive under the current litigation process. Thus, the introduction of a statutory severance payment will reduce the litigation cost for termination.

The higher the litigation cost, the higher will be a burden on the small firm workers relative to income. Thus, the litigation-cost-reduction device like the severance payment will be particularly helpful to the non-regular workers.

## ***IV. Other Reforms of the Employment System***

### **1. Exit Payment**

The voluntary practice of paying an exit payment has been hindering labor mobility in Japan for two reasons.

First, the funding for exit payments is not transferable to other companies.

Second, the amount of the exit payment usually increases more than proportionally to the duration of employment.

These two features of the exit payment make it more beneficial for workers to quit their job after many years of employment at one firm rather than only a few at many firms. Thus, the longer an employee works, the more he/she will lose by changing employers.

We have shown that the exit-payment system is a Ponzi scheme. But once it became common practice, the Japanese government provided special tax treatment to the exit payment in the income tax system, which locked the exit-payment system into Japanese employment practices.

The current practice of exit payments would have zero frictional impact on employment mobility if it were made portable.

Currently, each corporation accumulates funds for workers' exit payments. We propose to allow employers to transfer exit payment funds to a newly created Transitional Individual Retirement Accounts (TIRA) for defined contribution (DC) pension plans of the 401-K type.<sup>35</sup> Each TIRA account is portable, and the benefits paid from this account are the same whether the worker is dismissed or resigns.

One approach is to provide an incentive to provide a tax break for withdrawals from a TIRA up to the agreed severance payment, and no tax break to the lump-sum exit payment itself.

---

<sup>35</sup> Such pension plans are portable with defined contributions; therefore, they will not be affected by whether the person is dismissed or resigns spontaneously and serve as a third-tier pension system on top of the Employees' Pension System, which is the second tier of the pension system in Japan.

## **2. Reducing Litigation Costs**

Given the high cost of litigation in Japan, it may be useful to introduce subsidies to the litigation process for workers in small firms and to expedite the litigation process to honor all labor contracts of a firm. Regarding subsidies to the litigation process for dismissals, we can learn from Germany.<sup>36</sup>

---

<sup>36</sup> Yamamoto [2018].

## **Part 4: Conclusion**

### ***I. Nutshell***

Two problems confronting the existing employment system in Japan have made the legal prospects for the dismissal unpredictable. The first is that the doctrine of abusiveness of dismissal sets rather vague criteria and therefore allows the courts to determine whether a case of dismissal is abusive based on their deliberate decisions. The second is that the monetary compensation determined through reconciliation process vary widely. The resulting high termination cost has had a devastating effect on the welfare of the relatively disadvantaged while protecting the vested interests of the privileged, especially the low productivity workers earning high wages.

In this chapter, we have made two proposals to introduce Japan's severance payment system.

The first proposal is vacancy decontrol that applies to new employees either for a recently vacated positions or a new position. The decontrol allows firms to have agreements at the time of employment that freely sets the levels of severance payment while honoring the existing contracts at the same time.

Within this category, we proposed government-assisted vacancy decontrol, as a transitional measure. In this setting, we proposed a minimum level of statutory severance payment equal to six months of wages for a worker who has worked for twenty years, taking the Taiwan precedent as a model. One of the purposes of government-assisted vacancy decontrol is to temporarily fix a deficiency of the current system of unemployment insurance, which would induce a firm to dismiss excessively as soon as the decontrol eliminated the current high cost of termination.

After this problem is fixed in the unemployment insurance system, after both employers and employees are accustomed to making their agreements on severance payments, and after the financial measures to secure the severance payments are established, complete vacancy decontrol should be introduced, abolishing the statutory severance payment. We have proposed that even at this

stage, the government should publicly set a default level of the severance payment, which a firm should observe unless an explicit agreement or contract stipulates otherwise.

The second reform proposal, which applies to existing contracts, is the specification of a level of severance payment that would replace the current JRR after the case was determined to be an abuse. To this ends, it would be useful to standardize the level of the monetary compensation. Ohtake and Tsuru [2014] showed the average levels set by various court-mediated agreements for the worker with the combination of the wage rate and the number of work years before the dismissal. Based on this study, we propose to set the rate of severance payment equal to 12 months of wages for the model worker with 20 years of employment. If both parties can make a prior agreement, they could set the severance payment above the statutory level. The estimate by Kawata and Kawaguchi [2018] based on “full compensation” principle may be useful in setting such a private add-on. If the parties can not make a prior agreement, the statutory level has to prevail, though.

## ***II. Vacancy Decontrol***

Japanese severance payment literature has overwhelmingly focused on the introduction of a German-style severance payment as a replacement for the existing JRR. In this chapter, we also addressed the issue of severance payment for new contracts under vacancy decontrol. The reason is that the introduction of a German-style severance payment should not be the end of employment-system reform in Japan. Instead, it should only be a halfway house from the European concept of job protection, which resulted in the inflexible labor market in both Germany and Japan, to a less distorting employment system that respects freedom of contract.<sup>37</sup>

---

<sup>37</sup> Fukui [2006] argues that the literature has excessively focused on the severance payment as a replacement for the existing JRR. We propose vacancy decontrol in the present Chapter to rectify this situation.

The essential nature of the German reform is an improvement of existing contracts by allowing monetary compensation in lieu of the JRR for dismissed workers. This is not contradictory to giving a new worker a new type of employment contract. A remarkable example of such a reform can be found in Taiwan, where firms can offer a new severance payment to new contracts while honoring the existing contracts.

However, in Japan, even under the existing system, many workers earning high salaries in multinational banks and consulting firms have been dismissed with a contractual “just cause” severance payment offered. These same workers have not begun court procedures to fight the invalidity of their dismissal. So even in Japan, the market has chosen vacancy decontrol in sectors where the workers believe the time cost of litigation is too variable to forego the offered severance payment.

Another reason we focused on vacancy decontrol is that it can be immediately applied to retired workers. There will soon be an increasing number of people aged over 60 in Japan retiring from their lifetime employment firm and seeking a second job. Employers would be more than happy to hire retirees if they could dismiss them when it became clear that they were unfit for the firm, as they face an enormous risk as to whether these workers are more or less productive. Consequently, if firms can more easily dismiss ex-retirees they hired but who turned out to be unproductive, they would be more willing to employ retirees. This will create a better market for senior employment and workers will be selected based on their productivity. In turn, it will provide an incentive for even pre-retirement workers in lifetime employment firms to shape up their skills to improve their prospects for employment postretirement. An immediate application of complete vacancy decontrol to senior workers would give a great benefit to them.

### ***III. The Synergy Effects***

In this paper, we could have focused just on severance payments under vacancy decontrol, but we also discussed them as a possible replacement for the

JRR in existing contracts. This is because these two types of severance payments have synergy effects.

Once government-assisted vacancy decontrol progresses, many firms would be willing to hire new workers under the decontrolled type of contract. There is then no reason for these firms to employ only new college graduates, and so they will greatly increase their demand for mid-career workers. In other words, firms will be willing to pay higher wage rates to highly productive workers because they can risk hiring the workers without a lifetime commitment.

Conversely, introducing a severance payment system as a replacement for the JRR will enable firms to hire mid-career workers with high productivity by dismissing workers with less productivity from the firm's viewpoint. This dismissal will create a supply of mid-career workers in the labor market, which will match the increased demand for them created by vacancy decontrol. Further, workers employed in lifetime-employment system companies may be motivated to switch to one with a government-assisted vacancy decontrol system, which could pay higher wages for truly able workers.

Thus, the simultaneous introduction of the two types of severance payment systems should yield great synergy effects in facilitating labor mobility in Japan. This should improve the international competitiveness of both individual firms and the country.

#### ***IV. Freedom of Contract and Poor Workers with Weak Bargaining Power***

The legal system around the world would have often sacrificed freedom of contract in favor of protection of the poor or of those with weak bargaining power.

For example, an ostensible reason for rent control in the US is the protection of the poor renter whose bargaining power is weaker than the landowner. However, very rich people often live in the area protected by the rent control and young start-up workers who wish to live in a small flat in the center of a city are often unable to live there in the rent-controlled central cities. The true reason for the rent control is the protection of the existing renters, both rich and poor.



Realizing this problem, many cities and states in the US have been restoring free rent markets, while the Federal government gives rent subsidies to poor renters.

Another example is employment regulation in Europe and Japan. Again, the government intervenes the market to ensure job security, ostensibly because workers have weaker bargaining position than employers. But as a result of such an intervention, low productivity workers earning high income are often protected as regular workers in large firms, while the workers with achieved competence in some skills are excluded from employment for regular jobs. Restoring freedom of contract is the only way to give equal opportunity to everyone. And that is particularly true in the contemporary labor market. In the age of IT, information asymmetry has been reduced drastically, and the labor market can be potentially very flexible as long as legal system catches up the technology.

Once such a free contract starts, how can we protect the relatively poorer workers?

- First, the government can invest in job training for the dismissed workers.
- Second, the government can subsidize the cost of litigation in employment-related legal services for the non-regular workers and small company workers so that they can truly enjoy the freedom of contract.
- Third, the government can foster the development of the financial system that secures severance payment in case of dismissal.
- Fourth, the government can make sure to attain vacancy decontrol as quickly as possible. Vacancy decontrol will foster active and flexible labor market, which is instrumental in reducing the opportunity cost of dismissal. This is particularly important for senior citizens

Thus rent control and job security protection share very similar problem caused by government's intervention with the freedom of contracts. In both cases, we should assist the poorer people through policy tools directly aimed at the issue

rather than through a distortion of the market, which gives rise to various side effects including damages against the very people whom the intervention claims to have intended to help.

On the other hand, the money loan business is a successful case where the government has upheld freedom of contract. One could argue that borrowers of loans are in a weak negotiation position and that they need protection through allowing postponement of the due date for example. But in Japan, a borrower is required to pay back the loan within the due date. Otherwise, he is treated as having violated the contract. Because the government has upheld freedom of contract in money loan business, lenders can give loans even to the poor without fear of default. Also because of this, the appropriate insurance market has developed for default. As for helping the poor, welfare system is used. The money loan business gives important guidance to the reform of employment market.

This is the reason why we should not be content with improving the existing contract in the German style reform. Instead, we should try to renovate the employment system for new contracts, so that equal opportunity can be awarded to truly able workers. Our proposal for the government-assisted vacancy decontrol is the first step in that direction. Eventually, complete vacancy decontrol is attained by the legal stipulation that dismissal is valid if it is based on a prior agreement or contract, i.e., by allowing a firm to explicitly choose between just-cause employment and at-will employment as in the US.

# Appendix I: Ponzi Scheme

## ***I. The Expanding Economy***

Consider an economy where people work for only two “years.” In each year, the young and the old generations work concurrently in this economy. In the following, the *model year* is simply the *year*, without quotation marks. The *calendar year* is as written. One year is approximately 20 calendar years in the real economy.

## ***II. The Expanding Firm Model***

Consider a growing firm in this economy, which satisfies the following assumptions.

- (1) This firm employs workers for their lifetime. Thus, the firm employs young workers and retains them in the next year.
- (2) Every year, this firm’s employment of young workers expands at a constant annual growth rate of  $g$ .
- (3) In the first year, the firm has 1 old worker.

In the first year, therefore, the firm employs  $1 + g$  young workers, making total employment size  $2 + g$ , as shown in Table A. In the second year, the number of employees of both the older and young generations grow by a factor of  $1 + g$  and the total number of the employees in this firm is  $(1 + g)(2 + g)$ , also shown in Table A.

Table A. Labor Force

Generation \ Year	1	2	...	t
Young	$1+g$	$(1+g)^2$	...	$(1+g)^t$
Old	1	$(1+g)$	...	$(1+g)^{t-1}$
Total	$2+g$	$(1+g)(2+g)$	...	$(1+g)^{t-1}(2+g)$

Therefore, in year  $t$ , the employment size of the young is  $(1+g)^t$  and that of the old is  $(1+g)^{t-1}$ . The total employment this year is  $(1+g)^{t-1}(2+g)$ .

- (4) In this firm, the productivity of the young and the old are identical in any given year.
- (5) Productivity does not increase over time, and we assume that the productivity of all workers in any year is 1 throughout the period.

### ***III. The Merit-based Wage System***

This firm can adopt a merit-based wage system, where the wage rate is equal to its productivity, which is 1. Hence, the total wage payment in each year is the total employment in that year multiplied by one. Table B, which is identical to Table A, shows the wage payments to the young and old generations each year. This table shows that the wage payment of this firm in year  $t$  is  $(1+g)^{t-1}(2+g)$ .

Table B. Merit-based Wage Payment

Generation \ Year	1	2	...	t
Young	$1+g$	$(1+g)^2$	...	$(1+g)^t$
Old	1	$(1+g)$	...	$(1+g)^{t-1}$
Total	$2+g$	$(1+g)(2+g)$	...	$(1+g)^{t-1}(2+g)$

#### ***IV. The Seniority-based Wage System***

Alternatively, the firm can adopt a seniority-based wage system. In this setting, young workers receive zero wage, receiving the wage payment  $2 + r$  in their old age. Note that the remuneration for their work in old age is equal to 1 while the present value of their remuneration while young is  $1 + r$ . Thus, they add to  $2 + r$ , which they receive in their old age.

In the second year, the young generation again receives nothing. But the old generation receives remuneration for their work in the current year, which is  $1 + g$ , plus the present value of their remuneration in the previous year, which is  $(1 + g)(1 + r)$ . Thus, the combined wage of this generation in year 2 is  $(1 + g)(2 + r)$ .

Likewise, the older generation in year  $t$  receives remuneration for that year, which is  $(1 + g)^{t-1}$ , and the present value of their work in the previous year, which is  $(1 + g)^{t-1}(1 + r)$ . The total wage payment in year  $t$  is  $(1 + g)^{t-1}(2 + r)$ . Table B provides the details.

#### ***V. The Ponzi Scheme***

Thus, the wage payments in year  $t$  under the two systems are as follows.

Merit-based wage system:  $(1 + g)^{t-1}(2 + g)$

Seniority-based wage system:  $(1 + g)^{t-1}(2 + r)$

When  $g$  is greater than  $r$ , the total wage payment by this firm is smaller under the seniority-based wage payment than under the merit-based wage payment system. The employer clearly gains by adopting a seniority-based wage payment system. However, note that under either system, a given cohort receives exactly the same present value of wages. Thus, employers can gain by adopting a seniority-based wage payment scheme over a merit-based payment scheme without damaging the interests of workers.

This implies that the firm would still be better off than under the merit-based

system, even if it paid the present value of the wage of the previous year evaluated at a higher discount factor than the rate of interest. If the firm made this choice, both employers and employees would gain through the seniority-based wage scheme.

## VI. Productivity Improvement

So far, we have assumed that the productivity does not increase, and the wage rate remains constant. Now assume that the employment growth rate  $g$  is 0 in the Expanding Firm Model, and that assumption (5) is replaced by the following.

- (6) Productivity increases at a constant rate  $\alpha$  so that each new generation is equipped with new productivity, but each generation retains in old age the level of technology it acquired in its young age.

Replacing  $g$  in Table B with  $\alpha$  provides the output levels of each generation employed by this firm and the total output for each year. By reinterpreting Tables B and C as representing the merit-based and seniority-based wage systems respectively, where productivity increases at a rate  $\alpha$ , we again find that the firm can gain by employing the seniority-based wage scheme.

Table C. Seniority-based Wage Payment

Generation \ Year	1	2	...	t
Young	0	0	...	0
Old $\equiv$ Total	$2+r$	$(1+g)(2+r)$	...	$(1+g)^{t-1}(2+r)$
		$[ = (1+g)(1+r)+(1+g) ]$		$[ = (1+g)^{t-1}(1+r)+(1+g)^{t-1} ]$

Furthermore, assume that the productivity increase given by  $\alpha$  and the employment growth given by  $\gamma$  occur simultaneously, and we denote the sum of  $\gamma + \alpha$  as  $g$ . Tables B and C then provide the combined wage payments in each case. If we expect both productivity and employment levels to grow at some

constant rate, then  $g$  in Table B and C is the growth rate of the total wage payments in the firm where we expect both the employment level and the wage rate to increase.

In this situation, the gap between  $g$  and  $r$  can be substantial. For instance, during the period 1956–73 in Japan, the average growth rate per calendar year of secondary industry was 12.1%, while the average interest rate per calendar year on savings was 2.3%. The average annual gap is then 9.8%. Assume that one year in this model is 20 calendar years (as between age 30 and 50). Hence the 12.1% growth rate in a calendar year will approximately equal 242% growth rate in a model year, yielding  $g = 2.42$ .<sup>38</sup> On the other hand, the 2.3% interest rate on savings for the calendar year will translate to 45.6% interest rate in the model year, yielding  $r = 0.46$ .<sup>39</sup> If firms discount the payment of premiums at a factor between  $g = 2.42$  and  $r = 0.46$ , both employers and employees would significantly gain from this scheme. Thus, the firm is motivated to spontaneously adopt the combination of lifetime employment and a seniority-based wage system when it believes that  $g > r$  will prevail in the forecastable future.

Importantly, the seniority wage system is effectively a Ponzi scheme and the reason the firm can gain from this system. Under this system, the firm owes a debt to the young generation each year. Thus, the firm is indebted to the next generation each year. This means that the firm is eventually indebted to generations in the infinite future. The firm can then make a profit because it never has to return the debt to the generations in the infinite future. This profitability, however, relies on the presumption that  $g > r$  will continue.

However, the Ponzi scheme breaks down when the expectation of everlasting expansion is not actualized. That is exactly what has been happening in Japan over the past twenty years.

---

<sup>38</sup> Cabinet Office [2017].

<sup>39</sup> Research and Statistics Department in Bank of Japan. [2004].

## Appendix II. Non-firm-specific Human Capital

If a person accumulates general (non-firm-specific) human capital and if the skills improve accordingly, his wage rate will increase in a competitive economy under the merit-based system, where the wage rate is equal to the productivity of each worker. Thus, just because the wage level increases as the worker ages, does not mean that the wage structure is determined under a seniority-based wage system, which is where the wage rate becomes higher than the productivity as the worker's work duration becomes longer.

However, a worker who wishes to invest in such skills must accept very low wage levels when young. Given capital market imperfections, however, each worker may not be able to borrow from the bank to get by on a low wage during the investment period. Hence, it would benefit a worker if the firm makes an implicit contract with the worker to pay a wage rate *higher* than the productivity when young, in return for a commitment to remain in the firm. Therefore, in this case, the firm lends money and retrieves the return later, which is the opposite of the Ponzi scheme. Let us call this the case of *investment in the general human capital with an educational loan (GEL)*.

Suppose that the GEL, not the Ponzi scheme, is the only reason for the commitment to long-term employment. Then the wage rate would be below productivity after the worker completes the acquisition of general skills. Hence, the wage structure under this scheme is not a seniority-based wage as defined earlier; the wage rate would be less than productivity after the worker completes the acquisition of general skills. To prevent workers from resigning before returning their debt, created during investment in human capital, there is an incentive for firms to have a written agreement that secures a certain period of employment under this scheme.

However, in practice, most firms in Japan already employ a lifetime employment system based on the Ponzi scheme, and GEL is only an additional cause for any long-term commitment. Under the Ponzi scheme, wages will increase, and there is a handsome exit payment for long-time workers. Therefore, there is no incentive for workers to quit for reason of GEL. Based on these



grounds, there is no need for a written contract guaranteeing long-term employment. Alternatively, for the case of general human capital, workers will not forgo much by losing their job because their skills are marketable and firms wish to retain these workers as long as possible. However, this willingness weakens when there is a crisis, and the very existence of the business is threatened.

## **Appendix III. Employee's Public Pension and Dismissal Premiums**

In both Taiwan and Japan, an employee's public pension does not contribute to the dismissal premium. In Taiwan, all employees are eligible for the "labor pension" benefit at age 60 years, regardless of their length of service and the lack of employment continuity under the New Pension Scheme established in 2005. Thus, the level of pension benefit after retirement is unaffected by whether there has been a change in employer during the employee's career resulting from resignation or dismissal.

Just as Taiwan has a statutory portable labor pension, Japan has a statutory portable pension called the Employee's Pension System. They are similar in the following two respects.

- (1) Pension rights are equal regardless of resignation or dismissal.
- (2) Payments are in the form of the annuity starting at a statutorily determined age, although Taiwan provides an option of a lump-sum payment in addition to the annuity.<sup>40</sup>

In Japan, therefore, the level of pension benefit after retirement is unaffected by whether a change of employer during the employee's career resulted from resignation or dismissal; this is identical to the situation in Taiwan. Therefore, in both Taiwan and Japan, the employee pension does not contribute to the dismissal premium.

---

<sup>40</sup> A difference between the two systems is that Taiwan's labor pension is managed through Individual Retirement Accounts using a fully funded method (defined contribution base,) while Japanese Employee's Pension System is managed through a modified pay-as-you-go method.

## Reference

- Autor, David H., Donohue, John J., & Schwab, Stewart J. [2006]. "The Costs of Wrongful-Discharge Laws," *The Review of Economics and Statistics*, MIT Press, vol. 88(2), pp. 211-231. <https://doi.org/10.1162/rest.88.2.211>
- Bellinger, Michael A. [1989]. "Lifetime Employment in the United States: Can it Work?," *Perspectives on Business and Economics*, Paper 3.  
<http://preserve.lehigh.edu/perspectives-v07/3>
- Cabinet Office [2017]. *Systems of National Accounts, Gross Domestic Product Classified by Economic Activities (Major Industry Group), at Constant Prices (at market prices in the calendar year 1990)*. Government of Japan.  
[http://www5.cao.go.jp/j-j/wp/wp-je17/index\\_pdf.html](http://www5.cao.go.jp/j-j/wp/wp-je17/index_pdf.html)
- Cahuc, Pierre, Carcillo, Stéphane, & Zylberberg, André. [2014]. *Labor Economics (second edition)*. MIT Press, MA.
- Chang, Chyi-Herng. [2018]. "Severance Payment System in Taiwan: A Historical Perspective." In: Hatta, Tatsuo and Ouchi, Shinya. (Eds.) [2018]. *Severance Payment and Labor Mobility: A Comparative Study of Taiwan and Japan*. Springer, Japan.
- Fukui, Hideo [2006]. Dismissal Regulation Widened Income Gap. (Japanese title: 「解雇規制が助長する格差社会」 ). In: Fukui and Ohtake [2006].
- Fukui, Hideo. [2007]. *Let's Start Law and Economics with the Cases*. (Japanese title: 『ケースから始めよう 法と経済学』 ). Nippon Hyoron Sha Publishers, Japan.
- Fukui, Hideo and Ohtake, Fumio. (Eds.) [2006]. *Stopping the Widening of Income Gap and Employment Laws*. (Japanese title: 『脱格差社会と雇用法制』 ). Nippon Hyoron Sha Publishers, Japan.

- Hatta, Tatsuo. [1996]. Remark, in Hatta, Tatsuo et. al. (Eds.), *Investing in Human Services*. (Japanese title: 『福祉は投資である』 ). Nippon Hyoron Sha Publishers, Japan, 1996 .
- Hatta, Tatsuo [2006]. The Principle of Efficiency Improvement and Principle of Protecting the Vested Interests. (Japanese title: 「効率化原則と既得権保護原則」 ). In: Fukui and Ohtake [2006].
- Hatta, Tatsuo. [2009]. *Microeconomics II*. Toyo Keizai Inc., Japan.
- Holzschu, Michael. [2016]. *Just Cause vs. Employment-At-Will*.  
<https://www.businessknowhow.com/manage/justcausevsfreewill.htm>,  
 (accessed 2018-6-8).
- Huang, Yueh-Chin. [1991]. *Perspective on Labor Law 215*. Institute for Labor Research, National Chengchi University.
- Hyde, Alan. [2003]. *Working in Silicon Valley: Economic and Legal Analysis of a High-Velocity Labor Market*. Armonk, NY: M.E. Sharpe.
- Jo, Shigeyuki. [2006]. *Why Do the Youngs Resign their Job in 3 Years?* (Japanese title: 『若者はなぜ3年で辞めるのか?』 ). Kobunsha Co., Japan.
- Kawaguchi, Daiji. (Ed.) [2017]. *Japanese Labor Market—Economics Perspective*. Yuhikaku, Japan.
- Kawata, Keisuke & Kawaguchi, Daiji. [2018]. "Estimation for Monetary Compensation based on the Full Compensation Rule" (Section 7.) In: Ouchi, Shinya & Kawaguchi, Daiji. (Eds.) [2018]. *Reconsidering Unfair Dismissal in Japan: Design of Monetary Compensation System*. pp. 253–283. Yuhikaku, Japan.
- Laing, Derek. [2011]. *Labor Economics*. W. W. Norton and Company, NY.

- Li, Yu-Chun. [2018]. "Law Review and Comparison of Dismissal Regulations." In: Hatta, Tatsuo and Ouchi, Shinya. (Eds.) [2018]. *Severance Payment and Labor Mobility: A Comparative Study of Taiwan and Japan*. Springer, Japan.
- Liu, Chih-Peng. [1986a]. "On Labor Pension Claims (1)." *Lawyer Newsletter*, 79, pp. 25–26.
- Liu, Chih-Peng. [1986b]. "On Labor Pension Claims (2)." *Lawyer Newsletter*, 80, pp. 8–10.
- Liu, Chih-Peng. [1986c]. "On Labor Pension Claims (3)." *Lawyer Newsletter*, 81, pp. 11–14.
- Liu, Chih-Peng. [1986d]. "On Labor Pension Claims (4)." *Lawyer Newsletter*, 82, pp. 12–14.
- Liu, Chih-Peng. [1986e]. "On Labor Pension Claims (5)." *Lawyer Newsletter*, 83, pp. 5–9.
- Liu, Chih-Peng. [1986f]. "On Labor Pension Claims (last)." *Lawyer Newsletter*, 84, pp. 5–8.
- Nakamura, Takafusa. [1998]. *A History of Showa Japan, 1926-1989*. Translated by Edwin Whenmouth. University of Tokyo Press, Japan.
- National Conference of State Legislature. [2008]. *At-Will Employment - Overview*. <http://www.ncsl.org/research/labor-and-employment/at-will-employment-overview.aspx>, (accessed 2018-6-8).
- Noguchi, Yukio. [2010]. *The Year 1940 System (enlarged edition)*. (Japanese title: 『1940 年体制』 増補版). Toyo Keizai Inc., Japan.
- Ohtake, Fumio & Tsuru, Kotaro. [2016]. *A Statistical Analysis on Monetary Compensations for Dismissal (in Japanese)*. Paper presented to the Study Group of Settling Individual Disputes in the Ministry of Health Labor and

Welfare. 6 June 2016.

Ouchi, Shinya. [2013]. *"Dismissal Reform."* (Japanese title: 『解雇改革』 ).  
Chuokeizai-Sha, Japan.

Ouchi, Shinya. [2018]. "Why Should the Monetary Compensation System be Introduced in Japanese Dismissal Regulation?" In: Hatta, Tatsuo and Ouchi, Shinya. (Eds.) [2018]. *Severance Payment and Labor Mobility: A Comparative Study of Taiwan and Japan*. Springer, Japan.

Parsons, Donald O. & Shuaizhang, Feng. [2006]. "Insuring Displaced Workers: Human Capital Losses and Severance Pay Design." *IZA Discussion Paper*, No. 2238. July 2006. IZA Institute of Labor Economics, Germany.

Posner, Richard A. [2003]. *Economic Analysis of Law*. Aspen Publishers, New York, NY.

Research and Statistics Department in Bank of Japan. [2004]. *Financial and Economic Statistics Monthly, 14-1 Principal Interest Rates (1946–2004)*.  
[www.stat.go.jp/data/chouki/zuhyou/14-01.xls](http://www.stat.go.jp/data/chouki/zuhyou/14-01.xls)

Shiu, Howard & Chien, Irving. [2017]. "A Brief Introduction to Employment Termination and Severance Pay Systems in Taiwan – A Reference Model for Japan's Reform of Labor Mobility." In: Hatta, Tatsuo and Ouchi, Shinya. (Eds.) [2018]. *Severance Payment and Labor Mobility: A Comparative Study of Taiwan and Japan*. Springer, Japan.

Yamamoto, Yodai. [2018]. "German Law." (Section 4-2) In: Ouchi, Shinya & Kawaguchi, Daiji. (Eds.) *Reconsidering Unfair Dismissal in Japan: Design of Monetary Compensation System*. pp. 130–142. Yuhikaku, Japan.

Yashiro, Naohiro. [2018]. "Dismissal Compensation and Labor Mobility in Japan." In: Hatta, Tatsuo and Ouchi, Shinya. (Eds.) [2018]. *Severance Payment and Labor Mobility: A Comparative Study of Taiwan and Japan*. Springer, Japan.

Yoshida, Kazuo. [1994]. *"The Guilt of Japanese Style Bank Management."*  
(Japanese title: 『日本型銀行経営の罪』 ). Toyo Keizai Inc., Japan.